Internal Revenue Service

memorandum

CC:TL-N-5606-88
Br1:CEButterfield

date: MAY 11 1988

to: Regional Counsel, Southeast CC:SE
Attn: [redacted]

from: Director, Tax Litigation Division CC:TL

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subject: [redacted]

This responds to the request for technical advice dated April 14, 1988.

ISSUE

What is the correct placed in service date for Plant [redacted]. 0048-0200

CONCLUSION

The correct placed in service date of Plant [redacted] is [redacted], the date on which the unit was synchronized into the main power grid of the [redacted]. This conclusion is based on the assumption, discussed in more detail below, that the agreement between [redacted] and [redacted] does not alter by its terms the normal definition of critical testing.

FACTS

Construction on Plant [redacted] began in [redacted], under the sole supervision of the [redacted]. Due to lack of funds, [redacted] discontinued construction in [redacted]. In [redacted], after a sale of an undivided [redacted]% interest to [redacted], construction was resumed. A sale of an undivided [redacted]% interest to the City of [redacted] followed in [redacted], and an undivided [redacted]% share was conveyed to [redacted] in [redacted]. From this point on construction was funded by all owners in proportion to their interests, although the actual construction continued to be carried out by [redacted] as agent. Some subcontractors were apparently involved in the construction, but the majority of the work was performed by [redacted]'s own Construction Division, and the plant can fairly be characterized as self-constructed.

The risks of ownership were addressed in the ownership agreement, with [redacted] agreeing to obtain insurance of the risk as agent for the other parties. The licenses necessary to begin operation of the plant and generation of electricity

for sale had all been obtained prior to the synchronization date. No additional licenses were obtained between the synchronization date and the commercial operation date (which is the placed in service date claimed by [redacted]). Testing of individual components had taken place before the synchronization date. There is no indication of any agreement between [redacted], or [redacted] as its agent, and [redacted] or [redacted] (suppliers of the turbo generators and boilers, respectively) regarding any separate contractual definition of critical testing. Although some latent defects caused temporary shutdowns of the plant on several occasions after synchronization, critical testing of the components had been completed before that date. And as stated above, synchronization took place on [redacted].

The issue of whether there could be two placed in service dates for the same property has already been referred to the Interpretative Division by the Criminal Tax Division. In their February 12, 1987 response, the Interpretative Division concluded that only one date could apply to a single unit of property, and that they believed the synchronization date to be correct.

LEGAL ANALYSIS

Plant [redacted] is the subject of a safe harbor lease, as to [redacted]'s undivided [redacted]% interest, running from [redacted] buyer/lessors. In order for the safe harbor leases to be effective, the property must have been new section 38 property, that is it must have been placed in service within three months of the signing of the leases. I.R.C. § 168(f); Temp. Treas. Reg. § 5(c).168(f)(8). Placed in service is defined as "placed in a condition or state of readiness and availablitity for a specifically assigned function. If an entire facility is leased under one lease, property which is part of the facility will not be considered placed in service under this rule until the entire facility is placed in service." Temp. Treas. Reg. § 5(c).168(f)(8)-6(b)(2). Treas. Reg. § 1.46-3(d)(2)(iii) states that property will be considered in a state of readiness for its specifically assigned function when it is "operational but is undergoing tests to eliminate any defects."

In addition to these general considerations, the Service has published numerous rulings on the subject of placed in service dates for power plants. (The rulings were discussed in detail in a technical advice memorandum dated February 2, 1988, a copy of which we have already provided to you.) These rulings point to four general requirements that must be met before the plant will be considered placed in service. The necessary licenses must be obtained. The plant must be synchronized into the main

power grid of the operating company. Title and risk of loss must have passed from the agent in charge of construction to the owner of the plant. And critical testing of all components must be successfully completed. Rev. Rul. 76-256, 1976-2 C.B. 46; Rev. Rul. 76-428, 1976-2 C.B. 47; Rev. Rul. 79-203, 1979-2 C.B. 94; Rev. Rul. 79-98, 1979-1 C.B. 103, clarified in Rev. Rul. 84-85, 1984-1 C.B. 11.

As discussed above, and as you discussed in your memorandum, there were some licenses that had not yet been obtained by the date of synchronization. We do not believe that these licenses will be dispositive, or even particularly influential of the placed in service issue. Even the taxpayer's own expert admits in his report, at page 11, that the licenses standing alone would not be fatal to the [redacted] date as the placed in service date. The fact that none of the outstanding licenses were actually obtained between the synchronization date and the commercial operation date also weighs heavily in our favor. Moreover, although the licenses were necessary eventually for the continued operation of the plant, none of them were required before start up, an in fact their absence did not prevent the start up of operations.

Title and risk of loss were jointly held by the holders of undivided interests at the date of synchronization. Whether title and risk of loss had passed between [redacted] and [redacted] is relevant to [redacted]'s ability to convey an interest in the plant, but not for the determination of the placed in service date. The plant could, conceptually, have been placed in service by [redacted] before the conclusion of the ownership and operating agreements. What is also necessary is that control of the components, and of any subcontracted portion of the construction have passed to [redacted] as agent for the owners. We are aware of no restrictions in the agreements between [redacted] and the companies that provided the components of the plant that represented a shift of control. We understand the plant to have been self-constructed by [redacted], and we would expect components such as the boilers and generators to have been shipped with risk of loss and title passing on delivery to the site, with warranties carrying over. It would be wise to have our expert witnesses confirm this, however, particularly as the taxpayer has raised a question over a possible delay in placing the plant in service due to a malfunction of the boiler.

On this issue, and on the issue of critical testing, we would expect the taxpayer to raise the recent case of Consumers Power Co. v. Commissioner, 89 T.C. No. 49 (September 30, 1987), in which the Service prevailed in an argument for a later placed in service date (a date past the date of synchronization) than

the one urged by the taxpayer. Distinguishing factors between this case and Consumers are that the hydroelectric unit at issue in Consumers was constructed by subcontractors who did not surrender control until certain tests were completed. Critical testing and control were contractually defined and contractually linked, in terms agreed to (and probably insisted on) by the taxpayer. You have brought no similar provisions to our attention in this case, and given that the plant was self-constructed we would expect to find none. Provided that a review of the agreements between [redacted] for the owners and the suppliers of the components are reassuring on this point, we expect Consumers to be readily distinguishable.

The question of critical testing is the one on which the taxpayer places greatest reliance. In particular the report by their expert, [redacted] states that ongoing problems with a prototype boiler, necessitating the subsequent installation of baffles, and other structural modifications, prevented the completion of critical testing until the commercial operation date, [redacted]. By that date the plant had operated successfully at rated capacity for seven days. Linked to this argument is the assertion that the unit had not begun normal daily operation before the commercial operation date. It is clear from the revenue rulings cited above, particularly Rev. Rul. 84-85, that operation at rated capacity is not a prerequisite for a plant to be considered placed in service. Normal daily operation may be a consideration in establishing the four factors mentioned above, but it is evidentiary as to these four factors and does not constitute an additional consideration.

The arguments as to completion of critical testing, are, obviously, contrary interpretations of the facts. Barring an agreement between the supplier of the boiler designating a certain operational level as the completion of critical testing, we see no reason why our interpretation would be less likely to prevail than [redacted]'s. The existence of such an agreement, however, would make this case more like Consumers than like the cases described in the revenue rulings, and to be consistent with the arguments we have made in the past, we would have to recognize any agreement between the parties as to the definition of critical testing. Were there such an agreement, we do not believe that the taxpayer would have hesitated to bring it to our attention before this time, however the agreements between [redacted] and [redacted] must be reviewed before you draw your final conclusions, consistent with the positions taken by the Service in Consumers and the revenue rulings that preceeded it. The fact that [redacted] installed the baffles in the boiler may indicate some sort of continuing relationship beyond that of a warranty, and this must be explored. The repair of the broken locking pin by [redacted] was stated in the [redacted],

Engineering and Valuation Report to be pursuant to warranty, thus would not substantiate a delay in the completion of critical testing.

Generally our engineers have concluded, and the minutes of the board meetings, and monthly progess reports confirm, that critical testing of individual components was completed before synchronization of the unit. Otherwise production of power at post-synchronization levels could have done extensive damage to the components. The design flaws in the boiler requiring the addition of baffles can be considered to be in the nature of latent defects, making themselves manifest only at the highest levels of operation. In addition the plant produced electricity on a fairly regular basis from the date of synchronization, thus indicating that although testing was continuing for latent defects, the plant was available on that date for its intended use. [redacted] PLR 7920006; PLR 8525082. The existence of an agreement that the plant will be declared commercially operational on completion of a continuous run of certain duration will not prevent the unit from being placed in service at the beginning, rather than the end, of that run. Rev. Rul. 79-98, supra.

We would note that we agree that the property can only have one placed in service date, as the date is determined by the readiness of the property for its intended use, and not by the property in the hands of a particular taxpayer. We do not feel that the use of an earlier date by [redacted] is particularly more persuasive than the use of a later date by [redacted]. Under the operating agreement, [redacted] was bound to complete [redacted] by [redacted] of [redacted]. Failure to meet this deadline could have resulted in their being removed as operating agent. There were no doubt other factors, also possibly unrelated to the actual placed in service date, which resulted in their selection of the earlier date.

In sum, we feel that the agreement between [redacted] and [redacted] requires further review. If it can be demonstrated that the boiler was provided with risk of loss and control passing to [redacted] on arrival at the site and that there was no continuing agreement between those parties other than a warranty, this case will fall in line with our rulings on placed in service dates, rather than with the Consumers case. With this proviso, we agree that the appropriate placed in

service date is the date of synchronization, [redacted], and that the safe harbor leases should accordingly be disallowed.

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Attachment
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